

This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 04 BRASILIA 001879

SIPDIS

SENSITIVE

NSC FOR CRONIN
TREASURY FOR OASIA - DAS LEE AND FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D
USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DDEVITO/DANDERSON/EOL SON
DOE FOR SLADISLAW
USAID FOR LAC/SA

E.O. 12958: N/A

TAGS: [EINV](#) [ENRG](#) [EFIN](#) [KIDE](#) [OPIC](#)

SUBJECT: BRAZIL: DISPUTES CAST SHADOW OVER FUTURE ENERGY
SECTOR INVESTMENTS

REFS: (A) BRASILIA 1696, (B) BRASILIA 1686

1. (SBU) Summary. Investment disputes between U.S. investors and Brazil are currently concentrated in the country's energy sector. The majority of the disputes involve contracts for thermoelectric plants that were signed during a period of drought-induced energy shortage (2001-2002) with guaranteed payments regardless of whether any energy is produced. When the drought ended and the hydroelectric plants began to enjoy surpluses of less expensive energy, however, Petrobras (the GOB's petroleum sector parastatal) began to reconsider the high costs of maintaining the contingency energy. Fundamental issue revolves around the willingness of Petrobras and certain governors to challenge contracts they don't like and the inconsistent performance of the judiciary in enforcing these contracts. Although Brazil is actively encouraging foreign investment, these disputes with Petrobras and state governments have negatively impacted the investment climate in the sector. End Summary.

2. (U) This cable provides additional analysis and information on the cases submitted for the 2005 Section 527 Report on investment disputes and expropriation claims report (Ref A). This cable contains business confidential information and should be handled accordingly.

Background on Petrobras Thermoelectric Contracts

3. (U) In the context of a 2001-2002 drought-induced energy shortage in Brazil, Petrobras was called on by the GOB to partner in several gas-fired power plants, inter alia, Macae Merchant (with El Paso), Eletrobrás (with former Enron), TermoCeara (with MPX Energia stakeholders, which are the U.S. power group MDU and Brazil's EBX), and TermoRio (with NRG Energy). In all four cases, Petrobras signed contracts essentially guaranteeing the thermoelectric plants a minimum payment (to cover operational costs and provide an investment return) regardless of whether the plants were called on to produce energy or not. The presence of these thermoelectric plants has contributed significantly to the current strength of the energy sector (Ref B).

4. (SBU) Plagued by the heavy contingency payments, Petrobras began to review some its gas-fired power plant contracts, particularly those with the private sector, in search of a way to cut costs. The new Petrobras Director of Gas and Energy, Ildo Sauer, publicly stated that the company wanted to "clean up" its thermoelectric portfolio. Petrobras argued that because market conditions had changed and it was exclusively bearing the onus of the losses, the contracts were invalid. The losses to Petrobras have taken on political overtones as well as the former director of Gas and Energy at Petrobras, Delcídio Amaral, is currently the leader of Lula's PT party Senate caucus and the president of the congressional commission (CPI) installed to investigate corruption at the Brazilian postal service. Petrobras and Amaral have been called upon to explain the R\$ 2 billion "losses" incurred by Petrobras during Amaral's tenure due to the thermoelectric plant contracts.

Deals Gone Sour

5. (U) As a result of the changed market conditions, Petrobras has been seeking to either back-out of the contracts and/or purchase its partners' shares in the plants. For example, in January 2005, Petrobras ceased making payments to El Paso's Macae Merchant plant even though it was under contract to supply gas and buy the power generated at El Paso's plant, paying a minimum amount even if no power was generated. Petrobras filed a lawsuit against El Paso in New York claiming that the contract is no longer valid. In July an arbitral tribunal decided that

Petrobras must make its contract payments to El Paso into a judicially administered escrow account pending final judgment on the case. A decision by the court is expected in November 2005.

16. (U) In another case, for more than two years Petrobras refused to pay an arbitral award to NRG Energy, a U.S.-based independent power producer. In September 2001, NRG acquired from Petrobras a 50% interest in the TermoRio project in Rio de Janeiro. Under the terms of the contract, NRG had the right to require Petrobras to repurchase NRG's interests in TermoRio under certain circumstances. In April 2002, NRG exercised that right, but Petrobras refused to pay NRG. In March 2004, a Brazilian arbitral panel ordered Petrobras to pay NRG US\$80 million (plus interest to date of payment). Although Petrobras did not challenge the decision in any forum and assumed full control of TermoRio, Petrobras delayed paying the award. In September 2004, NRG filed a lawsuit to enforce the award in a U.S. Federal District Court. Only on February 25, 2005, did Petrobras pay NRG US\$ 70 million pursuant to a negotiated settlement of the dispute.

Thermoelectric Dispute with Parana State

17. (SBU) The thermoelectric disputes also include another case involving El Paso and Petrobras, but this time with the parastatal Parana State Electricity Company (Copel). In 1998, El Paso (60%), Copel (20%), and Petrobras (20%) created a joint venture (UEG Araucaria) to build a gas-fired-electricity generation plant at Araucaria, in southern Parana state. The contract was for El Paso to construct the plant, and Copel to both operate and maintain the plant. Although the plant was completed in September 2002, Copel operated the plant only briefly because of alleged technical problems. The 20 year contract between Copel and El Paso was for energy capacity, thus requiring payment to El Paso whether the plant was in operation or not. Although Copel made the contracted payments to El Paso for three months, when new Parana governor Robert Requiiao entered into office in January 2003, he reportedly directed Copel to stop making payments to El Paso. El Paso claims that the alleged technical problems are a ruse to enable the state governor to take over a majority share of the plant. El Paso initiated arbitration proceedings in Paris and the panel hearing the case is expected to reach a decision at the beginning of 2006. As with the Macae Merchant dispute, El Paso hopes to reach an amicable settlement because the company wants to continue to work in Brazil's energy sector -- transitioning from the electricity sector into the oil and gas sectors -- which would require maintaining good relations with Petrobras.

More Petrobras Contract Problems

18. (U) Although many of the thermoelectric plant cases have resulted in disputes, some have been resolved through negotiations. The press, however, has reported that the negotiations involved a bit of "arm twisting" by Petrobras. For example, in May Petrobras management approved the purchase of the thermoelectric plant TermoCeara from MPX Energia for US\$ 137 million; MPX Energia was 49% owned by U.S. Company Centennial Energy in partnership with Brazil's EBX. In May Petrobras also formally announced its purchase of the thermoelectric plant EletroBolt, originally built by Enron and now belonging to a consortium of banks, for US\$ 65.1 million. Petrobras has also been in negotiation with the Neoenergia (formerly called Guaraniana energy company) regarding the thermoelectric plant Termoacu, whose construction was halted initially because of a technical review by the Brazilian Electric Energy Regulatory Agency (ANEEL). It appears now that Petrobras will increase its stake in the company from 30% to 80% and may recommence construction. In short, Petrobras is making a concerted effort to cut its losses in the thermoelectric sector by forcing contract negotiations and/or buying out its partners.

19. (SBU) Banco Pactual's Pedro Batista told Rio and Brasilia EconOfs that investors have been watching Petrobras' renegotiation of its thermoelectric plant contracts with concern. According to Batista, any investors entering the market will have to calculate in the risk that contracts may not be fully respected.

Shareholder Agreement Problems

10. (U) Some of the investment disputes involve state governments which, following new elections, reneged on shareholders agreements. As detailed in Ref A, U.S. companies Mirant and AES, along with a Brazilian partner, through a joint venture, purchased 33 percent of the voting shares of the Minas Gerais state electric power company

(CEMIG) for US\$ 1.05 billion in 1997. The purchase price included a shareholders agreement giving the joint venture certain negative control (i.e., veto) rights over the management of CEMIG and the ability to nominate some of the executive officers. However, in 1999, a new state government took office and overturned the shareholders agreement in a lower state court. An appeal remains pending. In a non-energy sector case also detailed in Ref A, the State of Parana similarly unilaterally terminated the Shareholders Agreement. The State effectively retook ownership and management control of its sanitation company Sanepar, despite having sold a 40% stake in the company with a shareholders agreement that guaranteed minority shareholder protections. The courts have not yet ruled definitively on the case.

Comment

11. (SBU) The unwillingness of new administrations to honor contracts signed under a previous federal or state government makes investors leery of pursuing infrastructure projects that require a long-term commitment. While Petrobras' strategy to cut costs makes sense in terms of its financial bottom line, the end result has been to relegate the expensive thermoelectric plants to the role of a contingency source of electric energy, at the additional cost of reduced investor confidence. Although it appears that the thermoelectric plants may play an important role in the next few years because of delays in moving new hydroelectric plants forward (Ref B), that respite could be only temporary. Fundamentally, Brazil (whether at the federal, state, or parastatal level) must decide whether the security provided by thermoelectric plants is worth the associated costs, even when they are not in operation.

12. (U) This cable was coordinated with the Foreign Commercial Service and the Consulates General in Sao Paulo and Rio de Janeiro.

CHICOLA